What is the near-term global economic outlook?

An interim assessment

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11h00 Paris time

Pier Carlo Padoan
OECD Deputy Secretary-General and Chief Economist

The growth outlook is weak

- The global economy has weakened since spring, led by developments in the euro area where recession is again taking hold. Economies both inside and outside the OECD area have been adversely affected by the euro area crisis through trade and confidence channels.
- Ongoing balance-sheet adjustments and renewed declines in consumer confidence have kept household demand soft in many countries. Business investment growth has also been slowing, except in Japan where post-disaster reconstruction continues. In the euro area, weakness in the periphery is spilling over to the core.
- According to forward-looking indicators, the loss of momentum at the G7 level may persist through the latter half of this year, with the recession in the euro area and associated trade and confidence headwinds enduring. The United States is an exception with comparatively stronger growth reflecting *inter alia* progress in balance-sheet adjustment and improving housing market conditions.
- With the euro area crisis still the most important risk for the global economy, further policy action is needed to instil more confidence in the monetary union.

GDP growth in the G7 economies

Annualised quarter-on-quarter growth, in per cent[1]

	Year 2011	Year 2012	11Q2	11Q3	11Q4	12Q1	12Q2	12Q3	12Q4
United States	1.8	2.3	2.5	1.3	4.1	2.0	1.7	2.0	2.4
Japan	-0.8	2.2	-1.9	7.4	0.3	5.5	1.4	-2.3	0.0
3 largest Euro countries[2]	2.0	-0.2	1.2	0.8	-1.0	0.1	-0.3	-1.0	-0.7
Germany	3.1	0.8	1.8	1.5	-0.6	2.0	1.1	-0.5	-0.8
France	1.7	0.1	0.2	1.1	0.0	0.1	-0.2	-0.4	0.2
Italy	0.5	-2.4	1.4	-0.9	-2.9	-3.3	-2.9	-2.9	-1.4
UK	0.8	-[0.7] [3]	-0.4	2.4	-1.4	-1.3	-1.8	[-0.7] [3]	0.2
Canada	2.4	1.9	-1.0	4.5	1.9	1.8	1.8	1.3	1.9
G7	1.4	1.4	1.1	2.3	1.7	1.8	0.9	0.3	1.1

1. Based on GDP releases and high-frequency indicators published up to 04 September 2012. Seasonally and in some cases also working-day adjusted.

2. Weighted average of the three largest countries in the euro area (Germany, France and Italy).

3. The forecast for the United Kingdom does not account for the likely shift of activity from Q2 to Q3 due to the additional Diamond Jubilee bank holiday in June. The impact of the Olympics may also not be fully accounted for in these forecasts.

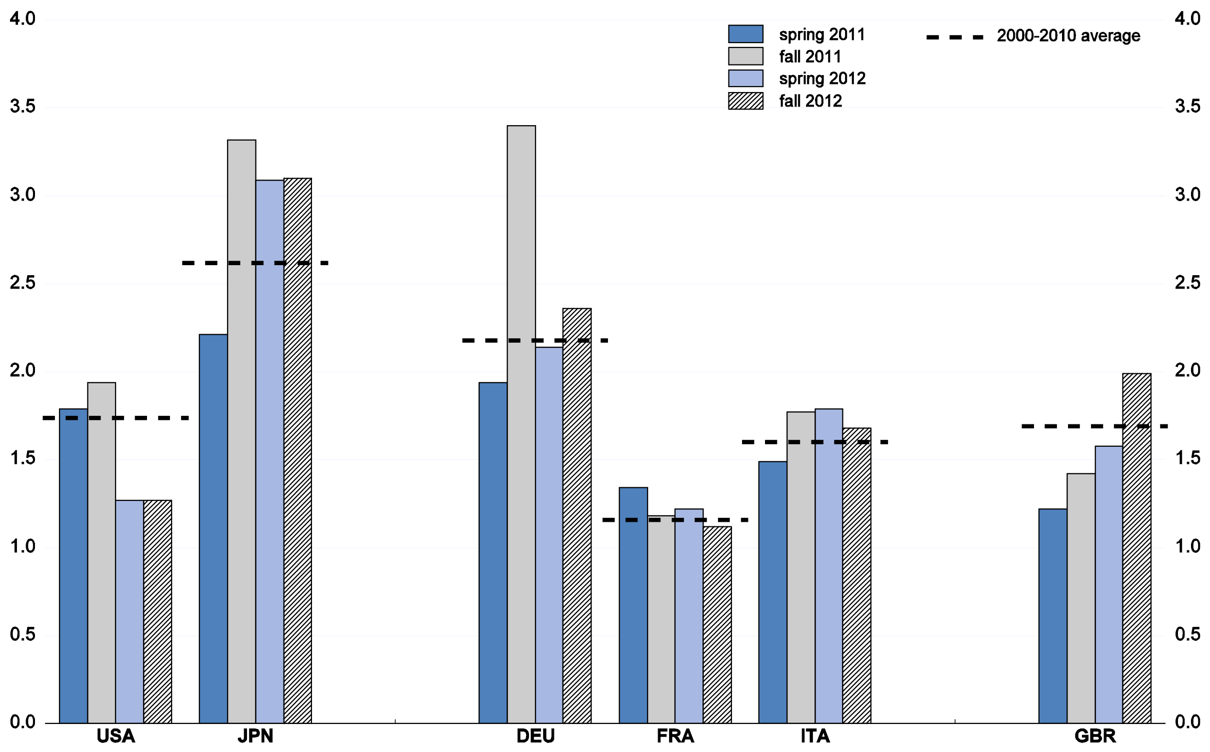
Note: See Appendix for underpinnings and status of the interim forecast.

Uncertainty around the near-term projections is high

- Uncertainty around the current forecasts remains at similar levels as in the previous Interim Assessment six months ago, except for Germany and the United Kingdom. In Germany, increased uncertainty may partly be related to the crisis in the euro area, while for the United Kingdom it may partly reflect uncertainties related to the shifting of activity from Q2 to Q3 due to the additional Diamond Jubilee bank holiday in June, and the impact of the Olympics.

Evolution of uncertainty around GDP forecasts

Standard deviation around forecasts, % of GDP, annualised rates[1]



1. The standard deviation combines two sources of uncertainty. First, uncertainty due to differences in forecasted GDP between the three models (soft-, hard- and mixed-indicator models) that are used to make the projections. Second, uncertainty around the GDP forecasts of each individual model is derived using quantile regressions, which allows some explanatory variables to have more weight in explaining GDP during a sharp downturn (or recovery) than in more normal times.

Note: See Appendix for a more detailed description of the methodology.

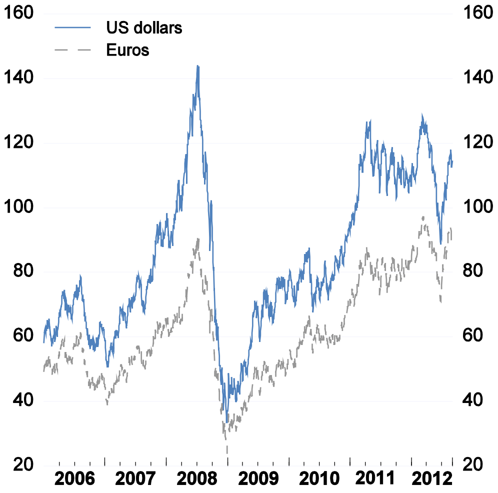
Source: OECD

Risks to the outlook remain significant

- A further intensification of euro area instability could have significant spillovers for global demand. Failure in the United States to avoid the “fiscal cliff” could derail an already weak recovery.
- Oil prices have rebounded despite recent soft activity and remain sensitive to supply disruptions and geopolitical risks.

Oil prices

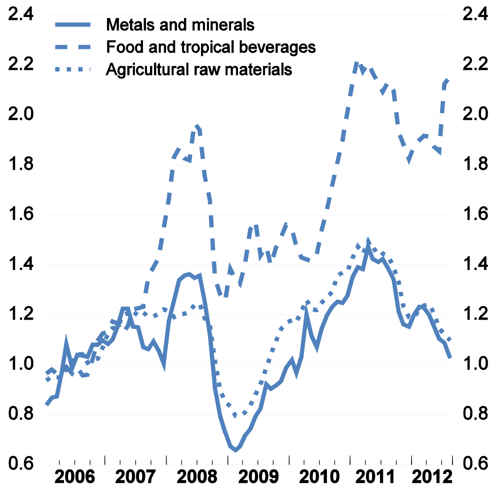
Crude oil (Brent price per barrel)



Source: OECD Main Economic Indicators; and Datastream.

Non-oil commodity prices

Index 2006 = 1



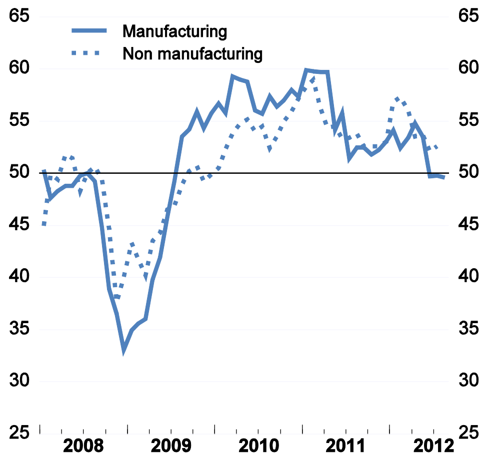
Source: OECD Main Economic Indicators; and Datastream.

The euro area crisis has hit confidence around the world

- The renewed intensification of the euro area crisis and falling output there have had adverse effects on confidence globally. Business confidence is particularly weak in the euro area and has dropped recently in the United States and Japan.
- The weakening in business confidence has been particularly evident in manufacturing sectors. This is consistent with waning indicators of global trade, such as export orders.
- Consumer confidence is weakening in most major economies. It is particularly weak in the euro area, and this is reflected to some extent in sharply contracting levels of lending to households.

Purchasing Managers Index (PMI) for manufacturing and non-manufacturing

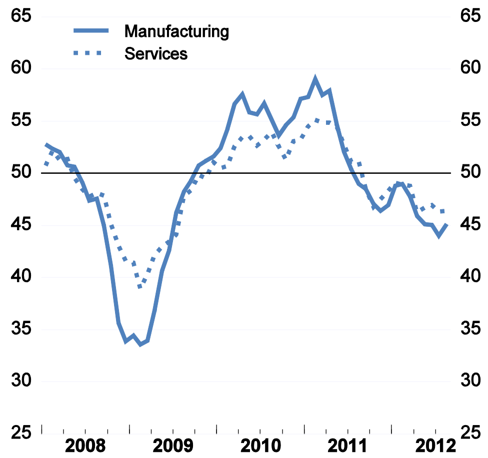
United States



Note: Values greater than 50 signify an improvement in economic activity. Source: Markit Economics Limited.

Purchasing Managers Index (PMI) for manufacturing and services

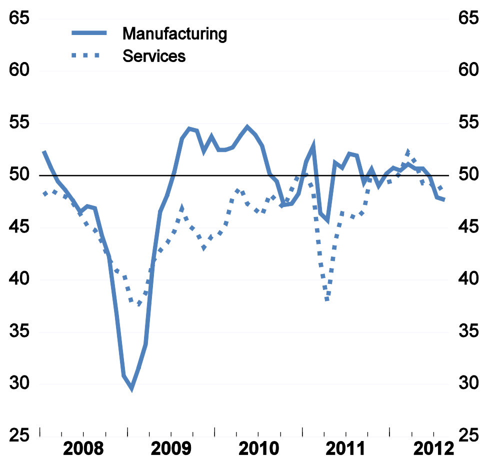
Euro area



Note: Values greater than 50 signify an improvement in economic activity. Source: Markit Economics Limited.

Purchasing Managers Index (PMI) for manufacturing and services

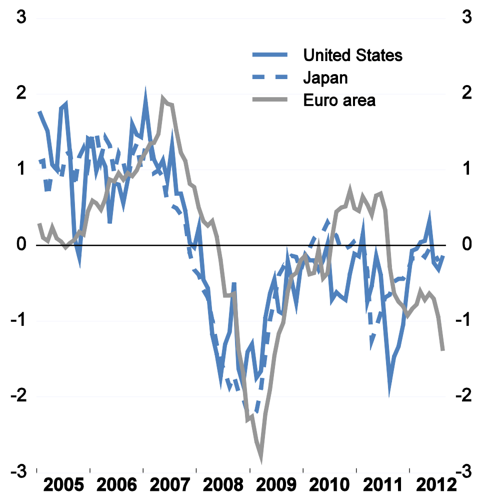
Japan



Note: Values greater than 50 signify an improvement in economic activity. Source: Markit Economics Limited.

Consumer confidence

Indices



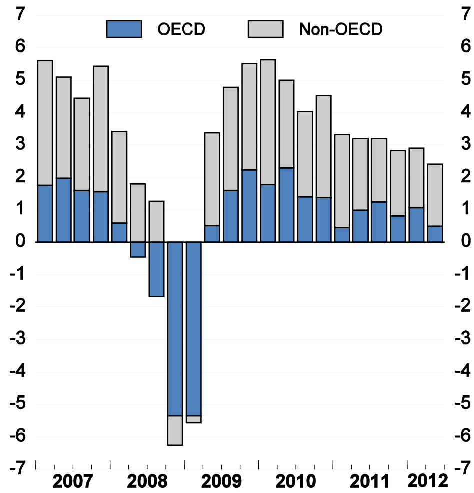
Note: Normalised at period average and presented in units of standard deviation. Values above zero signify levels of consumer confidence above the period average. Source: OECD Main Economic Indicators.

World output and trade have both decelerated markedly

- Recent indicators show global output and trade to have slowed in the course of the first half of the year and into the summer, a reflection of soft demand in most major economies, especially in the euro area, and also of weak activity in global hi-tech sectors. China's exports to the euro area are being hard hit.
- Likely durable changes are taking place in the geographical composition of global imbalances, with the euro area surplus rising on soft domestic demand and fiscal consolidation. In the United States an increasing non-oil deficit is offset by an improving oil balance, while high oil prices help to sustain the sizeable external surpluses for oil producers. The Japanese surplus is falling on rising energy imports and sluggish exports.

Contribution to annualised quarterly world real GDP growth

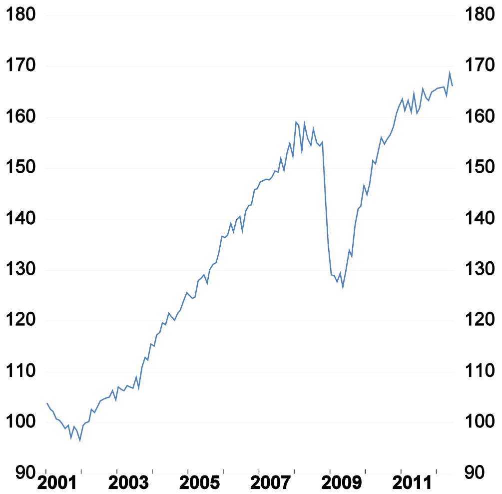
Percentage points



Note: Calculated using moving nominal GDP weights, based on national GDP at purchasing power parities. Last observation: Q2 2012. Source: National Accounts Database.

World trade

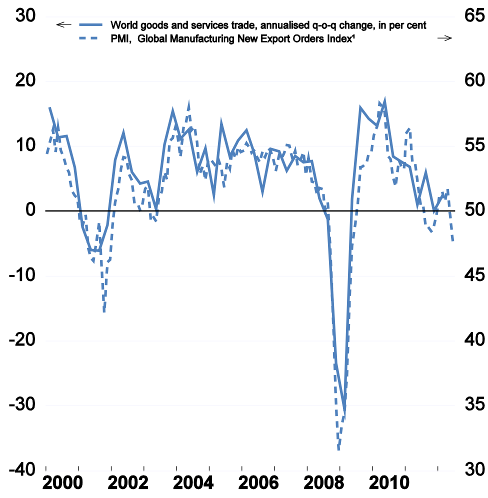
CPB indicator of world merchandise trade, 2001 = 100



Last observation: June 2012.
Source: CPB.

World trade

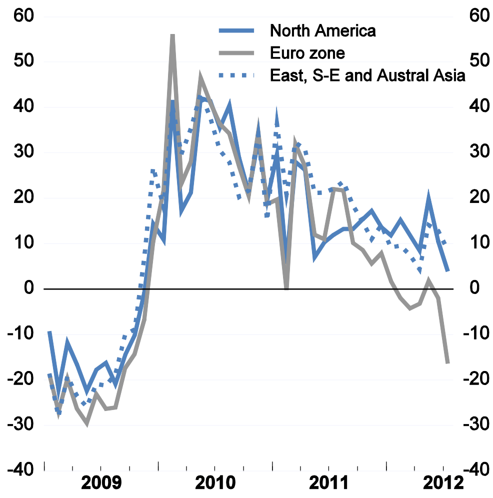
World goods and services trade and Global Manufacturing New Export Orders Index



Note: 1. Values greater than 50 signify an increase in new export orders. Source: OECD National Accounts database; and Markit Economics Limited.

China's exports by destination

Year-on-year growth, percent



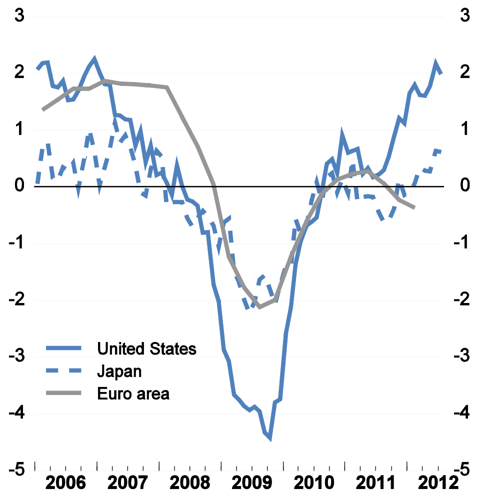
Source: CEIC.

Labour market developments are diverging

- Softening output growth is slowing job creation in most economies, although the impact on unemployment appears surprisingly muted in a number of countries.
- With a period of sub-par output growth seeming likely, there is a risk that unemployment could rise more rapidly than recently, with adverse effects on income growth, confidence and activity. Amongst other countries, both inside and outside the OECD, this risk is present in the United States.
- In all countries, but most especially in the euro area, labour market reforms are crucial to foster near-term employment growth, facilitate wage adjustment and reduce the risk that unemployment becomes entrenched. Product market reform, to relax regulation in sectors with a strong potential for new jobs such as retail trade and professional services, could also improve labour market outcomes relatively quickly.

Total employment

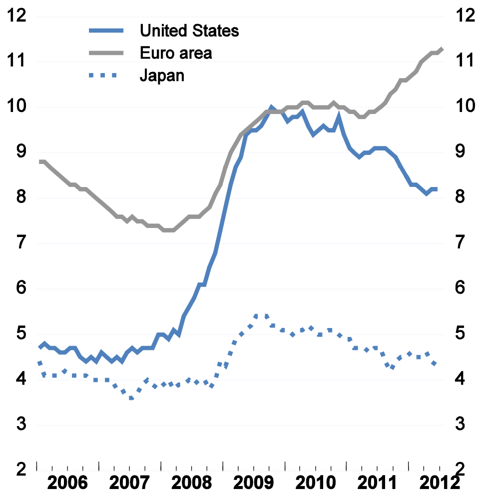
Year-on-year growth in percent



Note: Euro area based on quarterly series.
Source: OECD Main Economic Indicators, and Eurostat.

Unemployment rate

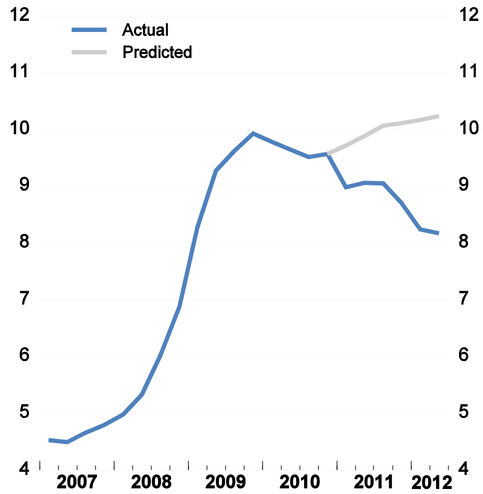
Percentage of labour force



Source: OECD Main Economic Indicators, Eurostat.

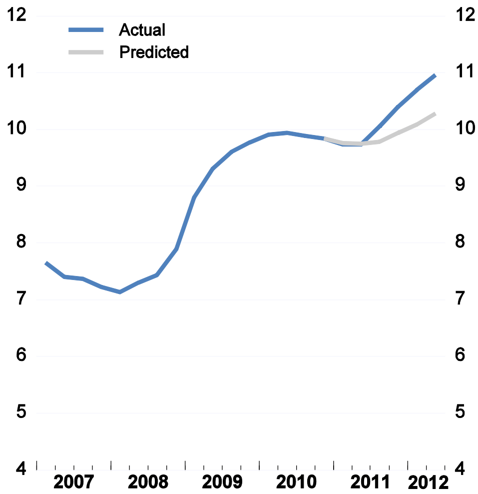
Actual and predicted unemployment rates[1]

United States, percentage points



Actual and predicted unemployment rates[1]

Euro area, percentage points



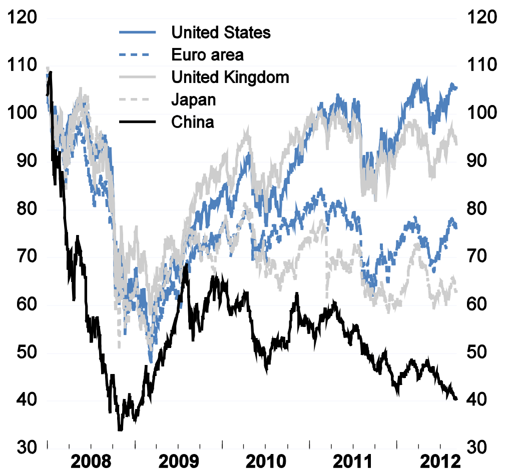
1. The predicted unemployment rate is calculated based on the historical relationship between the unemployment rate and output growth (Okun's Law) and actual growth outcomes. Source: OECD calculations.

Financial conditions have improved but remain sharply varied across countries

- The end-June agreement of the European Council to address the euro area crisis, cuts in key policy interest rates by the ECB in July and, more recently, the ECB announcing that it stood ready to intervene in sovereign debt markets, helped to provide stability in financial markets over the summer, despite difficulties facing the banking system in several countries.
- In the United States, financial conditions have improved in virtually all markets, while credit conditions eased or stabilised. In the euro area, stock markets have rallied and the declining currency is a positive for growth. Except for in China, financial market conditions in emerging markets have also improved recently.
- However, fragilities remain and are evolving, particularly in the euro area, where easy conditions in the core contrast with very tight conditions in the periphery. In the periphery, most banks are excluded from the funding markets, deposits are falling, and lending rates have soared.

Equity markets

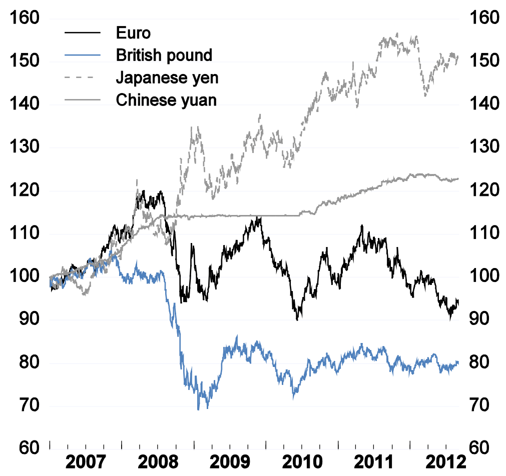
January 2008 = 100



Note: Wilshire 5000, FTSE Eurotop 100, FTSE 100, Nikkei 225, Shanghai Composite. Last observation: 04-09-2012. Source: Datastream.

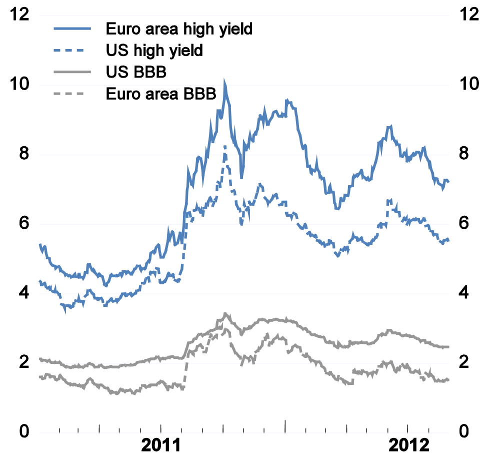
Exchange rates

USD per national currency, index January 2007 = 100



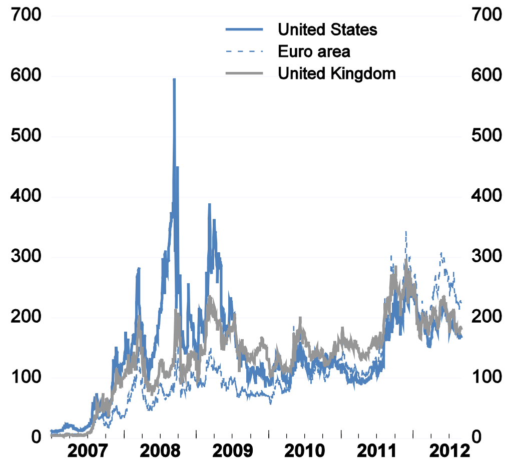
Source: OECD Main Economic Indicators.

Corporate bond spreads
Percentage points



Note: High-yield bonds (Merrill Lynch indices) less govt. bond yields (10-year benchmark bonds); corporate BBB rated bonds yields (Merrill Lynch - average for 5-7 & 7-10 years) less average govt. bond yields of same maturities. Last observation: 29-08-2012. Source: Datastream; OECD calculations.

Bank credit default swap rates
Basis points



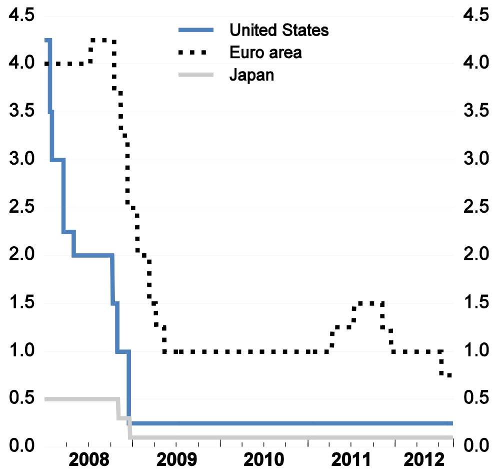
Note: Annual rates of five-year credit default swap contracts on very large banks, in basis points. Last observation: 29-08-2012. Source: Datastream.

Monetary policy could be even more supportive, especially in the euro area

- Where activity is weak and inflation under control, policy rates should be cut if they are still above zero, and asset purchase programmes could be expanded. In large emerging market economies, current policy should be continued or additional stimulus provided, depending on the country-specific outlook.
- In the United States, additional easing would have to be provided if the labour market situation were to deteriorate and fiscal tightening proves excessive in 2013. In Japan, the current policy stance needs to be maintained and asset purchases expanded if the trend out of deflation looks like faltering.
- In the euro area, the interest rate on the marginal lending facility should be lowered. The ECB should consider further action to help normalise monetary policy transmission in vulnerable countries, provided conditions are met in line with ECB guidance.
- In China, inflation has come down to an extent that further monetary policy loosening could continue – and should be accompanied by measures to boost the supply of new construction land.

Policy interest rates

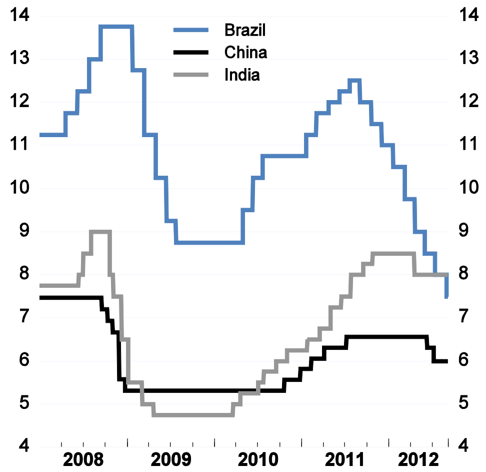
In percent



Source: Datastream.

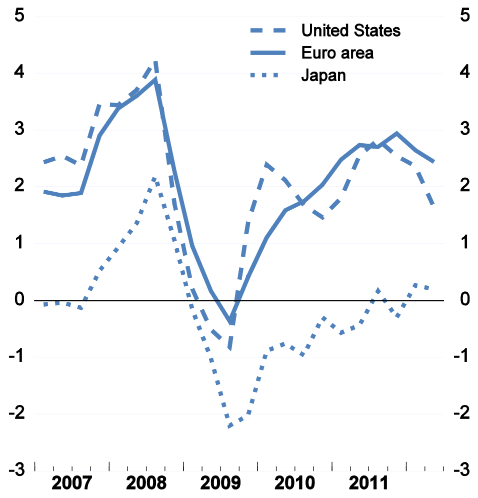
Policy interest rates

In percent



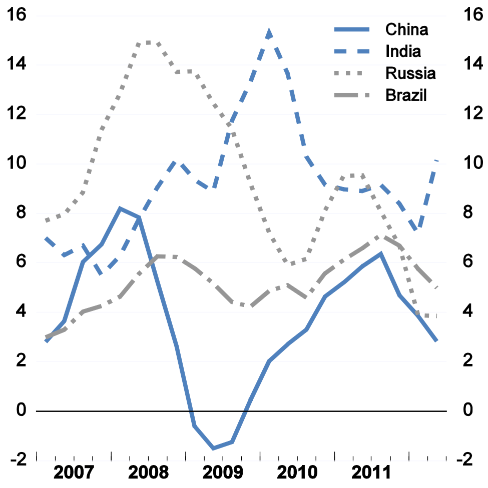
Source: Central Bank of Brazil; Reserve Bank of India; and CEIC.

Headline inflation
Year-on-year percentage change



Note: USA - PCE deflator refers to the deflator of personal consumption expenditures, Euro area - HICP refers to the harmonised index of consumer prices, Japan - CPI refers to the consumer price index. Source: OECD Main Economic Indicators.

Headline inflation
Year-on-year percentage change



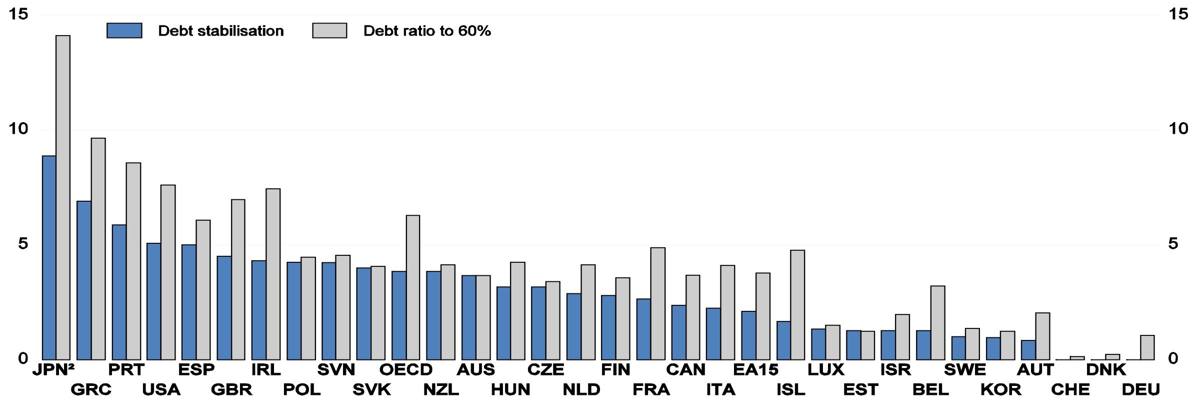
Note: Based on consumer price index. For India it is the industrial workers CPI. Source: OECD Main Economic Indicators.

Fiscal policy poses a risk in some economies

- Fiscal consolidation, while necessary from a medium-term perspective, is acting as a drag on short-term economic activity. An adverse feedback loop may be at work in some countries, with activity turning out weaker than assumed in budgets and thereby prompting overruns and further consolidation needs.
- In the United States, current legislation implies an extremely sharp fiscal tightening in 2013 ('the fiscal cliff') that would probably push the US economy into recession. It is urgent that the political parties agree on detailed medium-term consolidation plans that will avoid this outcome and reduce uncertainty regarding the fiscal outlook.
- In Japan, the planned increases of the consumption tax rate (from 5% to 8% in April 2014 and 10% in October 2015) is necessary but not sufficient to achieve the government's fiscal targets. Top priority should be given to establishing a detailed and credible consolidation plan.
- In the euro area, public finances remain under stress in many countries. They should continue to pursue their consolidation plans so as to meet the official deficit targets. While such pro-cyclical fiscal tightening is undesirable in principle, financial markets leave little leeway. Other countries have scope to let automatic stabilisers act partly or in full – or even to take stimulus measures in a few cases if conditions warrant.

Average necessary improvement in the underlying primary balance from 2011 to 2030

In percentage points of GDP[1]



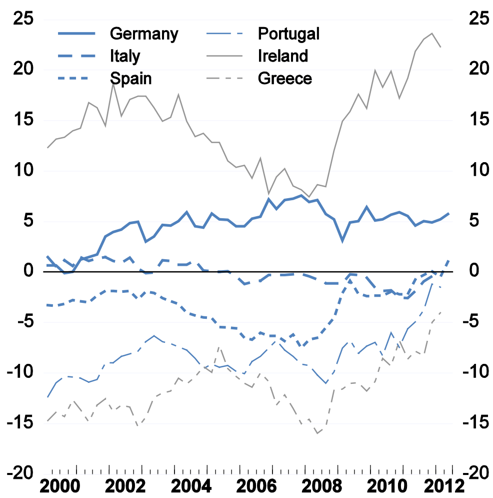
Note: 1. The bars show the average improvement in the underlying primary balance between 2011 and 2030 necessary to either stabilise government debt ratios or bring them down to 60% of GDP. When simply stabilising debt ratios, the average increase in the underlying primary balance over this period corresponds closely to the peak increase over the same period. When targeting 60%, however, the peak increase will be substantially higher than the average increase, but past the peak fiscal policy can be loosened and the underlying primary balance decrease before the debt ratio stabilises at 60% of GDP. In some cases the debt target is reached only after 2030. 2. In Japan's case, the average consolidation shown would be sufficient to stabilise the debt ratio but only after 2030. Source: OECD Economic Outlook 91 long-term database.

Euro area internal adjustments have begun, but there is a considerable way to go

- The necessary rebalancing of euro area economies is in most cases underway. Intra-area trade imbalances continue to narrow, with sharp declines in domestic absorption in the Troika programme countries and Spain.
- For imbalances to be durably reduced, growth-friendly adjustment and reforms are needed in both creditor and debtor countries.
    - In debtor countries, fiscal and external deficits must be reduced further through public-spending cuts and wage restraint, with structural reforms implemented to speed up the necessary reallocation of resources.
    - In creditor countries, domestic absorption needs to be increased, which will imply higher wages, more buoyant private consumption and investment and higher rates of inflation.
- The political and social challenges involved in the adjustment would be smoothed if it could take place against a background of stronger area-wide growth. The initiatives in the "Compact for Growth and Jobs" agreed at the end-June European Council are likely to have only a modest effect and should be complemented with decisive action to deepen the internal market, alongside reforms at the national level.

Euro area net exports

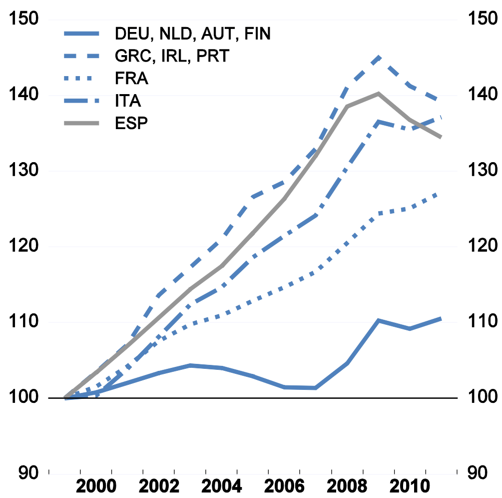
Percent of GDP



Source: OECD National Accounts Database.

Euro area unit labour costs

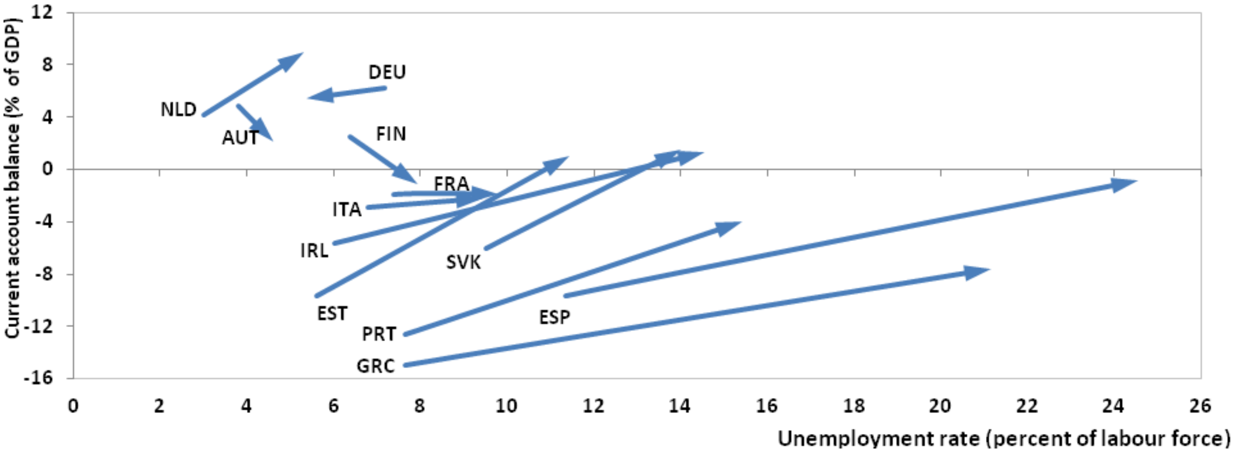
Index 1999=100



Note: Economy-wide unit labour costs. 2011 incorporates projections in the Economic Outlook. Country groupings constructed as a chain-linked aggregate using nominal GDP weights. Source: OECD, Quarterly National Accounts database.

Euro area rebalancing

Unemployment rate and current account balance, 2008 to 2012

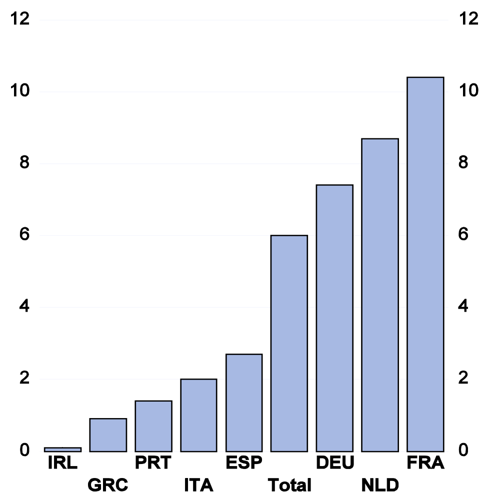


Three actions are needed to address adverse feedback loops that undermine the stability of the euro

- Solvency fears for banks and their sovereigns are feeding on each other. Full recognition of non-performing loans, enforced by common supervision, and the availability of area-wide public funds for recapitalisation are crucial for severing this feedback loop. Further progress towards banking union – including euro-area level deposit guarantees and a common bank resolution regime – is also crucial.
- Concerns about the possibility of exit from the euro area are pushing up yields, which in turn reinforces break-up fears. It is crucial to stem these exit fears. This could be achieved by the ECB undertaking bond market intervention to keep spreads within ranges justified by fundamentals.
- Worries about government debt also drive yields up, further weighing on debt dynamics. Markets provide a useful disciplining mechanism, but it can become destabilising when debt is high.

Additional capital required over mid-2012 levels to bring core Tier 1 capital to 5% of total assets

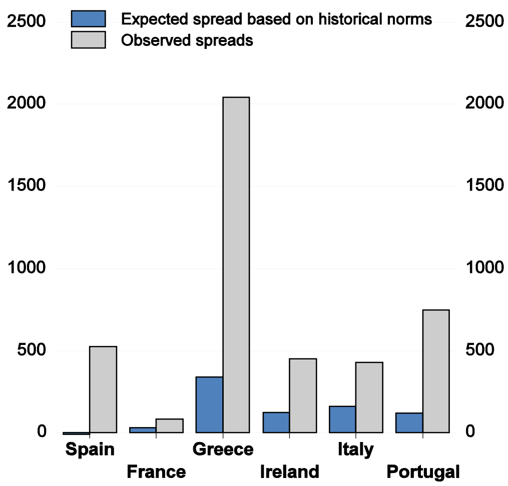
Indicative estimates, percent of GDP



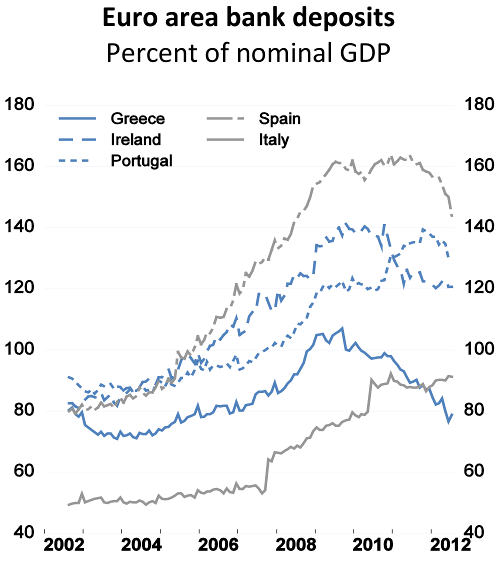
Note: Indicative estimates calculated based on a sample of 38 large euro-area banks scaled up to the size of the total assets of all banks (typically requiring an adjustment ranging from 1.3 to 1.7). Subordinated loan and other hybrid capital is not taken into account. The 5% benchmark equity ratio is based on the maximum leverage of 20-times (see Blundell-Wignall and Atkinson, 2012). Source: Bloomberg and OECD.

Euro area sovereign bond spreads: current levels compared with benchmarks

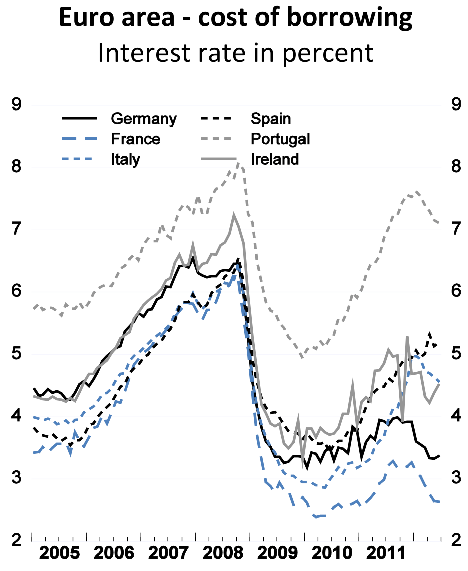
Ten-year spreads over German Bunds, basis points



Note: Actual spreads were calculated using ten-year benchmark bond yields retrieved from Thomson Reuters Datastream as of 4 September 2012. Expected (benchmark) spreads are based on past relationships between yields and debt ratios. Source: OECD calculations.



Note: Aggregated balance sheet of euro area monetary financial institutions excluding the Eurosystem. Last observation: July 2012. Source: Datastream; and ECB.



Note: New loans to non-financial corporations, up to EUR 1 million, with an agreed maturity up to 1 year. Last observation: June 2012. Source: Datastream.

Appendix

Underpinnings and status of the interim forecast

Since March 2003, the OECD has presented a brief overview of the near-term prospects in the major OECD economies between each issue of the *Economic Outlook*. This interim assessment should not be seen as a full update of the biannual *Economic Outlook* projections, since it rests on a more limited information set, has a shorter horizon and covers a much smaller number of economic variables and countries. However, it helps evaluate the extent to which the latest *Economic Outlook* projections are still on track for the larger economies.

In this context, the main tool is a suite of indicator-based models that serve to forecast real GDP for each of the G7 economies.* These models cover the two quarters following the last one for which official data have been published, with the different models receiving equal weights in the computation of the published forecast. They use a small, country-specific selection of monthly indicators, hard (*e.g.* industrial production, retail sales) and/or soft (*e.g.* business confidence). These models have been shown to outperform a range of other models relying solely on published quarterly data, as regards both forecast-error size and directional accuracy. The models used for the US and the UK economies have been modified to better capture the influence of developments in the housing sector, with the inclusion of various forward-looking housing indicators.

Details of the calculation of the standard deviation around forecast

The standard deviation combines two sources of uncertainty. The first source stems from the disagreement between the three models used to forecast GDP (based on soft-, hard- and mixed-indicators). The intuition is that when predictions from using soft and hard indicators diverge, uncertainty is higher. The second source is the uncertainty around the GDP forecasts of each individual model. This uncertainty arises because the relationship between the indicators and GDP is imperfectly known, and may vary depending on the underlying state of the economy. This type of uncertainty is estimated by forecasting the percentiles (100 intervals of equal probability) of the distribution of future GDP conditional on the indicators. The percentiles are estimated using quantile regressions which allow each explanatory indicator to have a different weight in explaining each percentile. This allows some explanatory variables to have more weight in explaining GDP during a sharp downturn (or recovery) than in more normal times. The standard deviation around each individual model is computed using these estimated percentiles. The global standard deviation, taking into account the two sources of uncertainty, combines the three model-specific sets of estimated percentiles.

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* See Pain, N. and F. Sédillot, "Indicator models of real GDP growth in the major OECD economies", *OECD Economic Studies*, No. 40, 2005 and Mourougane, A., "Forecasting monthly GDP for Canada", *OECD Economics Department Working Paper*, No. 515, 2006.